No. 15062

United States
COURT OF APPEALS
for the Ninth Circuit

HUGH H. EARLE, Former Collector of Internal Revenue for the District of Oregon, Appellant

v.

ANGELA MacEVOY WOODLAW, OTIS O. JAMES and STEPHEN W. MATTHIEU, Executors of the Estate of G. T. Woodlaw, Deceased, Appellees

On Appeal from the Judgment of the United States District Court for the District of Oregon

BRIEF FOR THE APPELLANT

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OPINION BELOW

The District Court rendered no opinion. Its findings of fact and conclusions of law (R. 41-51) are unreported.

JURISDICTION

Deficiencies in income tax for 1946, 1947 and 1949 were assessed by appellant, as Collector of Internal Revenue, against appellees, as executors of the estate of

G. T. Woodlaw, deceased. (R. 4-5.) Such deficiencies were paid with interest and within two years after payment claims for refund of a portion of the sums paid for each of the above years were filed with the Commissioner of Internal Revenue on September 30, 1952. (R. 6-24.) As no action had been taken thereon after the lapse of more than six months, appellees filed this suit in the District Court of the District of Oregon on September 21, 1953, within the time provided in Section 3772 of the Internal Revenue Code of 1939. (R. 3-7, 24.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1340. The case was tried before the District Court and judgment for appellees was entered on September 26, 1955. (R. 53.) Motion to set aside the judgment and to amend the findings of fact was duly filed by appellant and an order denying such motion but allowing additional findings of fact was entered on October 17, 1955. (Supp. R. 127-128.) Within sixty days thereafter the notice of appeal was filed on December 16, 1955. (R. 53-54.) Jurisdiction is conferred on this court by 28 U.S.C., Section 1291.

QUESTION PRESENTED

Whether payments made in the taxable years by the corporation here to its sole stockholder in connection with the purchase and retirement of one-half of its outstanding stock were distributions equivalent to a taxable dividend within the meaning of Section 115 (g) of the Internal Revenue Code of 1939.

STATUTE AND OTHER AUTHORITIES INVOLVED

The pertinent provisions of the statute and other authorities involved are set forth in the Appendix, *infra*.

STATEMENT

The pertinent facts as found by the District Court are as follows (R. 41-51; Supp. R. 128-129):

The appellees here are the executors of the estate of G. T. Woodlaw, deceased. The latter's income tax returns for 1946, 1947 and 1949 were filed with the then Collector of Internal Revenue for the District of Oregon; and after an investigation of such returns, deficiencies were assessed in the amount of $129,733.95 for 1946, $3,599.26 for 1947 and $30,080.52 for 1949. These deficiencies were paid with interest and timely claims for refund were subsequently filed on October 6, 1952. (R. 41-43.)

The Woodlaw Investment Company was organized under the laws of Oregon on April 15, 1920, and on February 6, 1946, its authorized and issued capital stock was 2,800 shares, of which all was owned by G. T. Woodlaw with the exception of qualifying shares. During 1946, Woodlaw sold 1,400 shares of this stock to the Woodlaw Investment Company[1] and in report-

[1]Plaintiff's Exhibit 15 (R. 100-101) states that the purchase of this stock was authorized by the company on February 9, 1946, and that it was being acquired for retirement.

ing this sale on his 1946 return, treated the proceeds as a capital gain to the extent that such proceeds exceeded par value of the stock. (R. 44; Supp. R. 128.)

The consideration for the above sale was $266,000, which was paid by the company to Woodlaw in the following manner: (1) cash in the amount of $163,000 paid in 1946, in the amount of $2,000 paid in 1947 and in the amount of $370.90 paid in 1949, (2) settlement in 1946 of debts due from Woodlaw in the amount of $40,225.15 and carried in an open account for the years 1930, 1931, 1932, 1939, 1940, and 1944, and (3) transfer in 1949 of a contract receivable valued at $60,403.95. (R. 44-45, 48-49.) For items making up the sum of $40,225.15 owed by Woodlaw, see R. 46-47, 49.

Agents of the Internal Revenue Service who examined Woodlaw's tax return for 1931 determined that amounts which were charged to his account during that year and which were included in the above sum of $40,225.15 were not dividends.[2] (R. 49-50.) Also, the parties agreed at the pre-trial hearing that no part of those 1931 withdrawal charges had been included in the taxable income of Woodlaw as dividends, or otherwise, prior to the cancellation of such indebtedness by the company in 1946. (R. 34.) Other withdrawals (not

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[2]The District Court's finding XVIII is in error in indicating that the 1931 withdrawal charges amounted to $40,225.15, and should read as given above. That our statement is correct is shown by those accompanying the claims for refund (R. 11, 17, 23), and by the agreed facts in the pre-trial order (R. 34). The same documents also show that the District Court was in error in stating (R. 49) that the account balance of Woodlaw on December 31, 1932, was $31,121.15. The correct figure is $39,121.15. (R. 10, 16, 22, 33.)

involved here) were determined to be dividends and income tax was paid thereon by Woodlaw. (R. 50.)

The Woodlaw Investment Company kept its books and made its tax returns on the cash basis. It had substantial undistributed profits and its surplus account as shown on its 1946 return is as follows (R. 48):

Beginning Surplus		$286,985.99
Profit for year 1946		35,357.15
Total		$322,343.14
Deduct Federal Income Tax Paid	$15,294.22	
Note Receivable Cancelled	1,000.00	
Income taxes 1946 (United States)	8,339.29	
Income taxes 1946 (State of Ore.)	3,215.07	27,848.58
Balance		$294,494.56

As to the years 1929 through 1949, the tax returns of Woodlaw Investment Company showed the following (Supp. R. 128-129):

Year	Net Income	Earned Surplus and Undivided Profits	Dividends Paid
1929		$114,013.22	
1930	$41,023.09	151,488.33	None
1931	23,839.86	170,294.38	None reported
1932	6,505.69	173,419.29	None
1933	9,708.71	191,630.47	None
1934	1,391,51	197,595.22	None
1935	(20,721.29)	159,683.77	None
1936	(1,910.12)	158,298.32	None
1937	5,149.90	164,022.89	None
1938	(14,305.29)	144,219.14	$5,241.60
1939	6,202.03	146,239.89	5,600.00
1940	10,330.69	156,351.97	None
1941	21,122.63	173,935.92	None

1942	26,962.84	195,495.91	None
1943	23,840.10	212,297.18	None
1944	31,867.63	239,551.18	None
1945	59,377.47	286,985.99	None
1946	35,357.15	180,048.92	None
1947	26,758.78	198,468.41	None
1948	30,730.73	222,651.98	None
1949	59,366.75	270,423.64	None

The Woodlaw Investment Company has been primarily engaged in the business of owning, leasing and renting of real estate in Portland, Oregon. (R. 48.) The District Court not only found that this company had continued in existence up to "the present time" but also found that it had continued in the same type of business. (Supp. R. 129.)

On October 12, 1945, the Woodlaw Investment Company sold its Gerlinger Building and on May 29, 1946, its Hamilton Building. It also sold some undeveloped lots in 1946. (R. 48.)

On the basis of the foregoing facts, the District Court found (R. 50):

> That the transaction wherein G. T. Woodlaw, deceased, received in the year 1946, $163,000.00 for 1400 shares of the capital stock of Woodlaw Investment Co. together with the additional sum of $2,000.00 in the year 1947 and a real estate sales contract in the year 1949 with a balance due of $60,403.95 with additional cash in that year in the amount of $370.90 was not a transaction equivalent to the distribution of a taxable dividend within the meaning of Section 115(g) of the Internal Revenue Code. The net effect of the distribution to the said G. T. Woodlaw was a distribution of

The District Court further found (R. 50):

> That there was in existence at the time of the transaction in 1946 involving the sale of the stock by the decedent, G. T. Woodlaw, to Woodlaw Investment Co. a legitimate business purpose therefor and Section 115(g) of the Revenue Act is inapplicable.

Upon the above findings, the District Court entered, as its conclusions of law (R. 51):

> That Plaintiffs are entitled to recover from the Defendant the sum of $153,550.92 with interest thereon at the rate of six per cent per annum from May 21, 1951, for the year 1946, and the further sum of $1,162.67 with interest thereon at the rate of six per cent per annum from May 21, 1951, for the year 1947, and the further sum of $31,688.38 with interest thereon at the rate of six per cent from February 5, 1951, for the year 1949 together with Plaintiffs' costs and disbursements herein incurred.

STATEMENT OF POINTS TO BE URGED

1. There is no evidence to support Finding of Fact No. XIX (R. 50) and the District Court was in error in making such finding which asserts:

> That the transaction wherein G. T. Woodlaw, deceased, received in the year 1946, $163,000.00 for 1400 shares of the capital stock of Woodlaw Investment Co. together with the additional sum of $2,000.00 in the year 1947 and a real estate sales contract in the year 1949 with a balance due of $60,403.95 with additional cash in that year in the amount of $370.90 was not a transaction equivalent to the distribution of a taxable dividend within the meaning of Section 115(g) of the Internal Revenue Code. The net effect of the distribution

to the said G. T. Woodlaw was a distribution of capital assets.

2. There is no evidence to support Finding of Fact No. XX (R. 50) and the District Court erred in making such finding which asserts:

> That there was in existence at the time of the transaction in 1946 involving the sale of the stock by the decedent, G. T. Woodlaw, to Woodlaw Investment Co. a legitimate business purpose therefor and Section 115(g) of the Revenue Act is inapplicable.

3. The District Court was in error in holding that the debt of $40,225.15 owed by G. T. Woodlaw to the Woodlaw Investment Company and written off by the corporation in the transaction was not taxable[3] as ordinary income to said G. T. Woodlaw at the time of the transaction.

SUMMARY OF ARGUMENT

The District Court erred in failing to hold that the payments made by a corporation to its sole stockholder in connection with the purchase and retirement of one-half of its outstanding stock were essentially equivalent to a taxable dividend, as the Commissioner determined. This question is one of fact and the decision of the District Court, being contrary to the evidence, is clearly erroneous and should be reversed.

Although the decision must depend on the circumstances of this case, there are relevant factors which

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[3]We have omitted the "not" in the first line of Point 3 in the record (p. 126) because it is obviously an error to include it.

have been repeatedly relied on in other cases and which should be considered here as a guide in deciding the issue. These factors are: (1) a pro rata cancellation of stock and distribution of cash, (2) closely held stock, (3) a large accumulation of earnings, (4) failure to declare dividends regularly, (5) intention to continue and actual continuation in business rather than liquidation, and (6) activity undertaken for reasons personal to a stockholder rather than for the benefit of the corporation. We submit that these factors are all present here. The record shows that Woodlaw, who did not die until after 1949, owned all of the corporation's stock, both before and after the purchase and retirement of one-half of his stock; that at the time such transaction was authorized, the corporation had an earned surplus of over $286,000, and that in 1946, 1947 and 1949 it turned over to Woodlaw $266,000. The record shows further that dividends had been declared in only two years since 1929, but during that time Woodlaw had frequently withdrawn money from his company and part of these unpaid debts was cancelled by being applied on the consideration paid by the corporation for Woodlaw's stock. It is well established that debts of a stockholder which are cancelled by a corporation constitute ordinary income, and we submit that that rule should be applied here for Woodlaw's debts, as well as the rest of the consideration paid for his stock, constituted a taxable distribution.

Our position is strengthened by the further fact that the corporation continued in existence, even after

Woodlaw's death, and also continued its regular business throughout the taxable years. Thus, while the record shows that a minor portion of the corporation's property was sold about the time the stock was purchased from Woodlaw, such sales do not prove that this was actually a step toward liquidation, as appellees have contended. Actually, the corporation retained the most valuable portion of its property and not only gave long-term leases on two of its buildings but increased its notes and accounts receivable in the year the stock purchase was made.

Furthermore, the testimony that Woodlaw wished to liquidate his holdings does not refute our contention. Being an old man, Woodlaw doubtless wished to settle his business affairs but his conversations with friends and business associates fall far short of proving that he was actually liquidating the business of the corporation involved here. And it is particularly significant that not a single witness referred to the purchase and retirement of Woodlaw's stock by the corporation. Thus, their testimony not only fails to show why the purchase was made but does not connect such transaction in any way with Woodlaw's alleged wish to liquidate his assets. Consequently, as no other portion of the evidence proves that there was in fact a business reason for the distribution to Woodlaw it is clear that it was made for his personal benefit and should be treated as taxable dividend.

ARGUMENT

The Sums Paid by the Woodlaw Investment Company Upon the Purchase of One-Half of its Outstanding Stock from its Sole Stockholder Were Essentially Equivalent to Dividends and Should Be Taxed in the Years Received as Ordinary Income

G. T. Woodlaw, who died after the taxable years here, reported on his 1946 income tax return that stock of the Woodlaw Investment Company had been sold by him to that company at a profit of $126,000 and that only one-half of that amount, or $63,000, should be taken into account for income tax purposes. (For tax return, see photostatic copy of Pltfs. Ex. 4.) The District Court apparently did not adopt this view. In holding that the transaction in which Woodlaw received cash and a contract was not a transaction equivalent to a distribution of a taxable dividend, as the Commissioner determined, the court found (R. 50) that "The net effect of the distribution to the said G. T. Woodlaw was a distribution of capital assets."

Accordingly, the issue here is whether the District Court erred in failing to hold that the payments made by the Woodlaw Investment Company in 1946, 1947 and 1949 to Woodlaw, its sole stockholder,[4] in connection with the purchase and retirement in 1946 of one-

[4]G. T. Woodlaw owned all of the stock except qualifying shares. (Supp. R. 128.) As to the qualifying shares, the record shows that one such share was held by Woodlaw's wife (R. 120), and presumably another was held by the secretary, J. M. Carson (R. 101).

half of its outstanding stock, were essentially equivalent to dividends under Section 115(g) of the 1939 Internal Revenue Code (Appendix, *infra*) and should be taxed in the years received as ordinary income. It is our position that the District Court's decision is clearly erroneous, and in so contending we shall not only point out that the court failed to consider and apply various tests which have been repeatedly approved in cases involving similar facts but shall show that the court reached a conclusion which is obviously not warranted either by its own subsidiary findings of fact or the supporting evidence in this case.

A. Applicable statutory provisions and nature of the issue here

The general rule as set forth in Section 115(a) of the 1939 Internal Revenue Code (Appendix, *infra*) is that any distribution either of money or property by a corporation to its stockholders constitutes a taxable dividend to the extent that the corporation has earnings. Code Section 115(c) (Appendix, *infra*) carves out an exception for distributions made in complete or partial liquidation of a corporation; and such distributions are treated as payments in exchange for the corporate stock although they may include earnings, but the scope of Section 115(c) is definitely limited by Section 115(g), the latter providing that—

> If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to

> the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

Section 115(g) was designed to prevent ordinary dividends from being disguised as liquidating dividends. See S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939-1 Cum. Bull. (Part 2) 332, 344) (Appendix, *infra*). Thus, it is evident that the retirement or cancellation of stock accompanying a corporate distribution should be ignored for income tax purposes if it does not serve to change the effect of the distribution as a taxable dividend to the extent of accumulated earnings and profits. See Code Section 115(b) (Appendix, *infra*).

We are, of course, aware that the question of whether a particular corporate distribution is a liquidating dividend within the meaning of Section 115(c) or is essentially equivalent to an ordinary dividend within the purview of Section 115(g) is a question of fact and depends upon the circumstances of each case. *Hirsch* v. *Commissioner*, 124 F. 2d 24, 28 (C.A. 9th). But the ultimate conclusion reached by the trial court on such question should be reversed when it is clearly erroneous, as we believe it is in this case. *United States* v. *Gypsum Co.*, 333 U.S. 364, 394-395, rehearing denied, 333 U.S. 869; *Commissioner* v. *Roberts*, 203 F. 2d 304 (C.A. 4th); *Chandler's Estate* v. *Commissioner*, 228 F. 2d 909 (C.A. 6th).

Moreover, notwithstanding the characterization of the question here as one of fact, there are certain fac-

tors which are relevant in distinguishing between a cancellation or retirement of stock which constitutes the essential equivalence of a taxable dividend under Section 115 (g) and the cancellation or retirement of stock which constitutes a partial liquidation under Section 115 (c). Accordingly, we shall discuss these factors before referring to the facts in this case.

B. Factors which have been held to be determinative of the issue here

As pointed out in *Woodworth* v. *Commissioner*, 218 F. 2d 719 (C.A. 6th), the views of some of the courts as to what tests should be controlling in deciding the issue here have changed[5] and it now appears to be the consensus that no single factor may be considered as decisive of such issue. But even with the varying views that have been expressed by the courts over the years, there are certain factors which have been repeatedly relied on in holding that a distribution is essentially equivalent to a taxable dividend. This being so, we think it is necessary that such factors should be considered here.

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[5]Among the cases cited as announcing views not now adhered to are *Patty* v. *Helvering*, 98 F. 2d 717 (C.A. 2d), and *Commissioner v. Cordingley*, 78 F. 2d 118 (C.A. 1st), holding that when the issuance of shares is bona fide, subsequent redemption thereof cannot be treated as equivalent to a taxable dividend; and *Commissioner* v. *Champion*, 78 F. 2d 513 (C.A. 6th), and *Allen* v. *Commissioner*, 41 B.T.A. 206, holding that a legitimate business reason for cancellation of stock is sufficient to prevent the application of Section 115 (g). Views which have been abandoned are also discussed in *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C.A. 2d) certiorari denied, 329 U.S. 726, and in 1 Mertens, Law of Federal Income Taxation (1955 Cum. Pocket Supp.), Sec. 9.123.

The factor which appears to have been most frequently mentioned and given greatest weight is a pro rata cancellation of stock and distribution of cash to the stockholders. Obviously, the reason for this is that a pro rata cancellation and distribution does not change the essential relation of the stockholders to the corporation. In other words, the cancellation of the stock is usually a mere formality and a stockholder's proportionate interest in and control over the corporation remains the same after such action as before. See *Chandler's Estate* v. *Commissioner, supra*, affirming *per curiam* 22 T.C. 1158; *Commissioner* v. *Roberts, supra*; *Flanagan* v. *Helvering*, 116 F. 2d 937 (C.A.D.C.); *Vesper Co.* v. *Commissioner*, 131 F. 2d 200 (C.A. 8th); *Stein* v. *United States*, 62 F. Supp. 568 (C. Cls.).

The importance of a pro rata cancellation has long been recognized in the Treasury Regulations. In regard to this, Section 29.115-9 of Regulations 111 (Appendix, *infra*) states, after pointing out that the question involved here is one of fact, that—

> *A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913.* On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. * * * (Italics supplied.)

All of the Regulations have contained this identical language since 1929.[6] Also, since then the identical language of Section 115 (g) involved here has been repeatedly reenacted. As the Regulations are clearly a reasonable interpretation of subsection (g) they must be deemed to have received the implied approval of Congress and should be given the force and effect of law. *Helvering* v. *Winmill*, 305 U.S. 79. Consequently we believe that a pro rata cancellation of stock is the most important single factor tending to show essential equivalence to a taxable dividend, and, as we shall point out below, that factor was present here.

Other factors which have been considered and relied on by the courts include (1) closely held corporate stock,[7] (2) large earnings and unnecessary accumulation of cash,[8] (3) failure to declare dividends regularly,[9] (4) intention to continue and actual continuation of business rather than liquidation of the business,[10]

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[6]See Section 19.115-9 of Regulations 103 (1940 ed.); Article 115-9 of Regulations 101 (1939 ed.), Regulations 94 (1936 ed.), and Regulations 86 (1935 ed.); and Article 629 of Regulations 77 (1933 ed.) and Regulations 74 (1929 ed.).

[7]*Chandler's Estate* v. *Commissioner*, *supra*; *Commissioner* v. *Roberts*, *supra*; *Bazley* v. *Commissioner*, 155 F. 2d 237, 239 (C.A. 3d), affirmed, 331 U.S. 737.

[8]*Hirsch* v. *Commissioner*, *supra*; *McGuire* v. *Commissioner*, 84 F. 2d 431 (C.A. 7th), certiorari denied, 299 U.S. 591; *Goldstein* v. *Commissioner*, 113 F. 2d 363 (C.A. 7th); *Hill* v. *Commissioner*, 66 F. 2d 45 (C.A. 4th); *Flanagan* v. *Helvering*, *supra*.

[9]*Hirsch* v. *Commissioner*, *supra*; *Boyle* v. *Commissioner*, 187 F. 2d 557 (C.A. 3d), certiorari denied, 342 U.S. 817; *Goldstein* v. *Commissioner*, *supra*; *Brown* v. *Commissioner*, 79 F. 2d 73 (C.A. 3d).

[10]*Rheinstrom* v. *Conner*, 125 F. 2d 790, 793 (C.A. 6th), certiorari denied, 317 U.S. 654; *McGuire* v. *Commissioner*, *supra*;

(5) purchase and retirement of stock not for the purpose of aiding the corporation but for reasons beneficial and personal to the taxpayer-stockholder,[11] and (6) facts showing that the net effect of a purchase and retirement of stock is to distribute corporate earnings just as if a cash dividend had been declared and paid.[12]

C. Facts showing that the ultimate conclusion of the District Court is clearly erroneous

The record shows that at a special joint meeting of stockholders and directors of the Woodlaw Investment Company held February 9, 1946, the three persons present passed a resolution authorizing the purchase and retirement of 1,400 shares of that company's capital stock. (Pltfs. Ex. 15; R. 100-101.) At that time there were 2,800 shares of stock outstanding, and with the exception of qualifying shares, all of the shares were owned by G. T. Woodlaw. (R. 44, 100; Supp. R. 128.) The 1,400 shares which were allegedly purchased[13]

Commissioner v. *Straub*, 76 F. 2d 388 (C.A. 3d); *Vesper Co.* v. *Commissioner*, *supra*.

[11]*Smith* v. *United States*, 121 F. 2d 692 (C.A. 3d); *Bazley* v. *Commissioner*, 155 F. 2d 237 (C.A. 3d), affirmed, 331 U.S. 737; cf. *Commissioner* v. *Snite*, 177 F. 2d 819 (C.A. 7th).

[12]*Bazley* v. *Commissioner*, 331 U.S. 737; *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C.A. 2d), certiorari denied, 329 U.S. 726; cf. *Commissioner* v. *Estate of Bedford*, 325 U.S. 283. See also *Smith* v. *United States*, 121 F. 2d 692 (C.A. 3d); *Hirsch* v. *Commissioner*, *supra*; *Flanagan* v. *Helvering*, 116 F. 2d 937 (C.A.D.C.); *Hyman v. Helvering*, 71 F. 2d 342 (C.A.D.C.), certiorari denied, 293 U.S. 570.

[13]We refer to the 1946 transaction as an alleged purchase and retirement because it is doubtful if the transaction was one which could be, or ever was, legally recognized, and this appears to be the view of the appellees, one of whom was Woodlaw's attorney. As to the latter's views, see Exhibit A accompanying each claim for refund and stating that "Action of the corporation in the pur-

and retired by the company were sold by Woodlaw, and after that transaction, the latter still owned all of the outstanding stock except qualifying shares. From these facts, it is, of course, obvious that the distribution made to Woodlaw and the retirement of his stock was necessarily pro rata and it is equally obvious that the stock was closely held. Thus, it must be admitted that the first two factors listed above are present here and are strongly supportive of our position here. The importance of such factors was pointed out in *Commissioner* v. *Roberts*, 203 F. 2d 304 (C.A. 4th), when the Court in considering facts similar to those here said (p. 306):

> The vital thing here, as we see it, is that, by the redemption of this stock, the *essential relation* of the taxpayer to the corporation was not, in any practical aspect, changed. Before the redemption, he was the sole stockholder in the corporation; after the redemption, he was still the sole stockholder. Of what real consequence was it that before the redemption his sole ownership was divided into 2,000 shares, and after the redemption, this same sole ownership was divided into 1,500 shares: He owned the whole corporation before the redemption; after the redemption, he was still the sole owner.

Thus, although the Fourth Circuit recognized in the *Roberts* case, *supra*, that the issue there, which was the same as in the instant case, was usually considered one of fact, it held that the Tax Court had erred in failing

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chase of its stock standing in the name of G. T. Woodlaw was not authorized by its Articles of Incorporation and Bylaws and was, therefore, ultra vires." (R. 12, 18, 24.) If that view is correct, it strengthens our position that the distributions were in fact earnings and must be treated as taxable dividends.

to hold that the distribution to the stockholders in that case was essentially equivalent to a taxable dividend under Section 115 (g). Consequently, it reversed the Tax Court's decision. We submit that the Fourth Circuit's statement is equally applicable here. Woodlaw's relationship to his company and his control over it were exactly the same after the sale as before, and there was no change in the company's business. In other words, the company's business, which was owning and leasing real estate (R. 48), was still carried on as before and was all transacted for the benefit of Woodlaw. Certainly such facts are significant, but they were not considered important by the District Court.

The next two factors listed under Subheading B above are also present here. These are a large accumulation of corporate earnings and a failure to declare dividends regularly. The income tax returns of the Woodlaw Investment Company show (Supp. R. 128-129) that for 21 years (i.e. from 1929 through 1949) the company had a large amount of earned surplus and undivided profits. In fact, at no time was such amount less than $114,013.22 (amount for 1929) and in 18 of the years covered by the returns, the earned surplus and undivided profits not only exceeded $150,000 but in most of those years it was considerably larger than that figure. The highest amount ($286,985.99) was reported for 1945 and that was also the beginning surplus for 1946. (R. 48.) We think that fact is significant since the resolution for the purchase and retirement of stock was passed very early in that year (i.e. on February 9). (R. 100.)

The significance of such resolution is still more clearly seen when we contrast the large accumulation of earnings with the very small amount of dividends declared in the years referred to. No reason is given in the record for the failure to declare regular dividends but we know that, as sole stockholder and president of the Woodlaw Investment Company, Woodlaw could, of course, have paid dividends at any time. Nevertheless, dividends were actually paid in only two of the 21 years covered by the record, and then the total for those two years (1938 and 1939) was only $10,841.60. In another year (1931), none was reported but the record shows (R. 50) that Internal Revenue Agents required Woodlaw to treat some of his withdrawals from the company in that year as a taxable dividend.

In this connection it should be noted that although Woodlaw was obviously unwilling to have dividends declared, he had no hesitancy in borrowing money from his company from time to time and in letting such debts run without payment for years. The record does not give the total amount of these loans but it does show that from 1930 through 1944 some of his withdrawals amounted to $40,225.15 and that sum was treated as a part of the price that the company agreed to pay for Woodlaw's stock. (R. 45-50.) Appellees contended in the District Court, without giving a definite reason, that such cancellation was not "a distribution equivalent to a dividend in any event" (R. 36), and from the ultimate decision reached by the District Court, we presume that it agreed. However, the Court

did not make a statement to that effect and we are in doubt as to its view because it not only made a separate finding (No. XXI) as to these debts which were treated as a part of the purchase price but stated therein that "part of the income attributable to the taxpayer arose out of the write-off of $40,225.15 shown due on the books of Woodlaw Investment Co. from decedent, G. T. Woodlaw". (R. 50-51.) From this finding it is evident that the District Court should have held that the amount of this debt was taxable income.

As this Court pointed out in *Hirsch v. Commissioner*, 124 F. 2d 24, 29, it is an established principle of tax law that if a person borrows money from a corporation in which he owns stock and his debt is subsequently cancelled, income accrues to him at the time of the cancellation and such income must be treated as a taxable dividend. To same effect, see also *Wiese* v. *Commissioner*, 93 F. 2d 921, 922 (C.A. 8th), and *Allen* v. *Commissioner*, 117 F. 2d 364, 368 (C.A. 1st). We submit that the above principle should have been applied here to Woodlaw's debts which were cancelled. While they were allegedly cancelled in connection with a purchase of his stock, the purchase was merely a device for distributing earnings and the entire amount of these debts, as well as the rest of the consideration for the alleged purchase, should have been treated as a distribution of earnings.

It is our further contention that the remaining factors listed under Subheading B are also present here, i.e. the continuation of the corporation in business and

the retirement of corporate stock for reasons beneficial to a stockholder, who, in this case, owned all of the corporation's stock both before and after such transaction. The facts which determine the issue are: In December, 1945, the corporation had earned surplus and undivided profits of over $286,000. (Supp. R. 129.) In 1946, 1947 and 1949 it turned over to its sole stockholder $266,000. Woodlaw did not die until after 1949 (R. 39) and the corporation continued in existence in the same type of business up to at least October, 1955 (Supp. R. 129) which was nearly nine years from the date of the alleged proposed liquidation. The record is devoid of any evidence of a business purpose for the retirement of the corporation's stock and, as we shall point out more fully below, it did not help the corporation in any way.

Even if Woodlaw did plan, either in his capacity as sole stockholder or as president and general manager of the Woodlaw Investment Company, to liquidate his company at some unknown future date (and as we shall show that is all the evidence indicates even when interpreted most favorably to appellees) it is not what Woodlaw thought he might do in the future but actually what was done at the time of the alleged purchase that is important in determining the issue here. This was forcefully brought out by this Court some years ago in *Hirsch* v. *Commissioner*, *supra*, when, in discussing Section 115 (g), it approved the statement in *Smith* v. *United States*, 121 F. 2d 692 (C.A. 3d) that (p. 29):

> The statute is aimed at the result. The basic criterion for the application of Section 115(g) is 'the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation.' *Flanagan* v. *Helvering* [73 App. D.C. 46], 116 F. 2d 937, 939, 940.

For other cases reaching the same conclusion as to Section 115(g), see *Boyle* v. *Commissioner*, 187 F. 2d 557 (C.A. 3rd), certiorari denied, 342 U.S. 817; *Jones* v. *Dawson*, 148 F. 2d 87 (C.A. 10th); *Rheinstrom* v. *Conner*, 125 F. 2d 790 (C.A. 6th), certiorari denied, 317 U.S. 654; and *Hyman* v. *Helvering*, 71 F. 2d 342 (App. D.C.), certiorari denied, 293 U.S. 570.

We submit that if this Court's interpretation of Section 115(g) is applied here, it is clear that the District Court's decision is erroneous for the alleged purchase was not in fact a step toward liquidation but was merely a distribution of a portion of the company's large accumulation of earnings, and should be treated as equivalent to a taxable dividend.

D. Erroneous basis for District Court's decision

The basis for the District Court's decision here is a matter about which we should not have to conjecture but it will be seen that neither in its findings of fact (R. 41-51; Supp. R. 128-129) nor conclusions of law (R. 51) does the District Court indicate specifically the reason for allowing the claimed refunds. However, it seems advisable to discuss what appears to be the basis for its decision in view of what the appellees contended below and doubtless will contend in this Court.

We assume that the primariy basis, if not the only basis, for the District Court's decision is found in its Finding XX (R. 50) which states:

> That there was in existence at the time of the transaction in 1946 involving the sale of the stock by the decedent, G. T. Woodlaw, to Woodlaw Investment Co. a legitimate business purpose therefor and Section 115(g) of the Revenue Act is inapplicable.

Thus, it appears that the District Court refused to apply Section 115(g) here because of the existence of a "legitimate business purpose" for the sale but it did not explain what the business purpose was and its nature cannot be determined from its findings. However, from the contention of the appellees below (R. 36) we assume that the District Court may have referred to an alleged intention on the part of Woodlaw to liquidate his company. If this is correct, we assert that such intention is not conclusively proved by the evidence, nor does the evidence show that the purchase and subsequent payment to Woodlaw was made to carry out either a partial or total liquidation of his company.

The record shows that the consideration for the alleged purchase of Woodlaw's stock was paid to him pursuant to a resolution which was passed by the stockholders and directors of the Woodlaw Investment Company on February 9, 1946, and which stated merely that 1,400 shares of that company's stock was to be purchased and that Woodlaw was instructed to make the purchase. See Pltfs. Ex. 15. (R. 100-101.) From this it is apparent that the resolution contained no hint

of any plan to liquidate nor any reason whatsoever for the purchase. But if there was "a legitimate business purpose" for the purchase of such stock, it would seem that such purpose would have been stated in the resolution. Certainly it is customary when a serious step like liquidation is planned for a corporation to indicate this in its minutes but the company here did not do so. But actions of a corporation are even more important than its statements as to a proposed liquidation. Indeed, corporate intent to liquidate can best be determined "by the acts and doings of the corporation" for liquidation is a "condition brought about by affirmative action, the normal and necessary result of which is winding up the corporation". *Beretta* v. *Commissioner*, 141 F. 2d 452, 454 (C.A. 5th).

Obviously, no "acts and doings" of the corporation here brought about liquidation for the District Court found that the company continued to exist and was carrying on the same type of business up to "the present time". (Supp. R. 129.) Furthermore, there is no evidence that the company intended to liquidate when the purchase of stock was authorized on February 9, 1946, or that there was any other business reason for such action. Thus, the District Court's finding (R. 50) that there was *then in existence* a legitimate business purpose for such transaction is not supported by the record. But it was, of course, known by Woodlaw that his company had the largest accumulation of earnings (i.e. $286,985.99) it had had since 1929 and that no dividend had been paid since 1939 (Supp. R. 129),

and we submit that it was this large accumulation which was the primary reason for the action taken.

But in arguing otherwise, appellees will undoubtedly point to certain sales of property that were made by the company and to the testimony of the witnesses relative to an alleged intention to liquidate. As to the sales, the District Court found (R. 48) that the company sold the Gerlinger Building on October 12, 1945, the Hamilton Building on May 29, 1946, and some undeveloped city lots also in 1946 but no dates were given for the latter sales.[14] No reason is given by the District Court for these sales but Matthieu, one of the appellees and also attorney for Woodlaw, testified (R. 105) that the latter formulated a plan to liquidate all of the assets of his company in December, 1945. However, the record shows nothing to indicate that any affirmative action had been taken by the company toward the alleged liquidation on February 9, 1946. Furthermore, there is no evidence of any actual steps being taken thereafter toward winding up the company's business.

On the other hand, there is substantial evidence to support the District Court's finding (Supp. R. 129) that the company continued in existence and carried on its same type of business. This evidence shows (R. 105-106) that the company retained four pieces of property after the sales referred to above and three of

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[14]From the testimony of Matthieu, it appears that one lot was sold in February and the other lots were sold in April of 1946. (R. 104.)

these pieces made up one-half of a city block. It is obvious that the property which the company retained made up the bulk of its assets and was much more valuable than the pieces which it sold. Indeed, Woodlaw priced the half block at a million dollars when he made an unsuccessful attempt to sell the property in the fall of 1947 (R. 68-69) and although his price may have been excessive, we know that the property was valuable. This is shown by the company's income tax return for 1946 which shows that at the beginning of that year the company had assets of $546,781.80 and that at the end of the year it still had assets of $511,641.11; and these figures are the values given after a generous allowance for depreciation. (See photostatic copy of Deft. Ex. 9.)

As we have already indicated, the company carried on its regular business during all of the taxable years involved here and afterwards up to the time of the hearing in this case. Among these activities was the leasing of two of its buildings. One of these, the Fourth Avenue Hotel, was leased in 1946 to Morris Rogoway and this lease was still in effect at the time of trial. (R. 67.) The other building, the Circle Theater, was rented in May, 1947, to Theodore R. Gamble under a long-term lease. (R. 108.) Thus, the company's regular activities were carried on and its revenues continued to come in as in previous years.

Moreover, the company's 1946 return indicated that there were still other transactions. We know this because its notes and accounts receivable were increased

from $85,726.35 at the beginning of 1946 to $106,786.82 at the end of the year. Also, under a subdivision of the return entitled "Bonds, Notes and Mortgages payable" we find a liability listed at the end of 1946 in the amount of $146,774.85. As no explanation is given, we do not know why the company incurred such a liability but we may properly infer that it was the result of some business activity in that year, or to obtain cash to distribute to Woodlaw.

Accordingly, we contend that the foregoing facts relative to the company's activities refute the contention of the appellees that the Woodlaw Investment Company had undertaken either a partial or total liquidation of its business. Furthermore, appellees' contention is not proved by the testimony here that Woodlaw wished to liquidate his holdings. Obviously, there is a difference between the desire to settle one's business affairs by liquidation at some future time and actually taking steps to do so; and when the testimony here is analyzed it will be seen that it shows merely that Woodlaw had told some of his friends and business associates that he was old and thought he should settle his affairs by liquidating his assets. However, some of the witnesses were not sure as to the year when they talked to Woodlaw, others did not know whether he referred to property he held personally or to property held by the Woodlaw Investment Company and some indicated that the conversations had touched on the matter of liquidation only in a very general way. (R. 59-60, 62-63, 68-69, 71-72, 76-77.)

Even Matthieu, who testified about the sales of property referred to above, did not indicate any other specific action which was taken by the Woodlaw Investment Company and we submit that under the circumstances here such sales do not prove an intent to liquidate its business. Moreover, the record shows that the company retained the bulk of the property and carried on its regular business, including the execution of two long-term leases after the retirement of Woodlaw's stock. (R. 105-108.)

But the most significant thing to notice here is that neither Matthieu nor Woodlaw's wife nor any of the other witnesses referred to the purchase of Woodlaw's stock by his company or gave any indication that it had ever been discussed with them. Consequently, there is nothing in any of the testimony that connects such purchase and the distribution of cash and property to Woodlaw with the latter's intention to liquidate his holdings.

In this connection, it should be noted that after Matthieu indicated that Woodlaw had formulated a plan to liquidate his assets, he was asked what was actually done in furtherance of Woodlaw's plan and he replied that a vacant lot was sold in February, of 1946, some others in April of the same year, and the Hamilton Building in May, also of that year. (R. 103-104.) Thus, it is apparent that Woodlaw's attorney (who is also one of the appellees here) did not consider the purchase of Woodlaw's stock as a part of the alleged plan, and neither do we. Of course, we do not admit

that these sales of a minor portion of the company's property indicated that the company had actually started to liquidate its business but even if it should be held that it does, there is nothing in the record here to connect such sales with the purchase and retirement of Woodlaw's stock. That was done, as we have already pointed out, merely as a way of distributing some of the large accumulation of earnings.

CONCLUSION

The decision of the District Court is clearly erroneous and should be reversed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [as amended by Secs. 166 and 186(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Dividend.* — The term "dividend" when used in this chapter (except in section 201 (c)(5), section 204 (c)(11) and section 207 (a)(2) and (b)(3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

(c) [as amended by Sec. 147 of the Revenue Act of 1942, *supra*] *Distributions in Liquidation.*— Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts

distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

* * * * *

(g) *Redemption of Stock.* — If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * *

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

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(26 U.S.C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.115-9. *Distribution in Redemption or Cancellation or Stock Taxable as a Dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the dis-

tribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939-1 Cum. Bull. (Part 2) 332, 344):

Partial Liquidation.

Section 201(g): It has been contended that under existing law a corporation, especially one which has only a few stockholders, might, without resorting to the device of a stock dividend, be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example: Assume that two men hold practically all the stock in a corporation, for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders, for cash, one-half of the stock held by them and cancel it without making the stockholders subject to any tax. Yet this action, in all essentials, would be the equivalent of a distribution through cash dividends of the earned surplus. The subdivision as rewritten by the House bill is intended to make clear that such a transaction is taxable and the committee approves the provision, which obviously does not apply in cases of complete liquidation of all the stock of the corporation.

The House bill provided that the amendment should be retroactive to January 1, 1925. The committee recommends that the provisions of the 1924 Act in this respect remain in effect during the calendar year 1925 and that the change in the law should become effective only as of January 1, 1926.